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Secured Transactions in Poland: Practicable Rules, Unworkable Monstrosities, and Pending Reforms

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I. INTRODUCTION

Poland has undertaken an ambitious program for the privatization of its banking industry.[1] There has been considerable interest, especially within the European banking community, in entering the relatively large Polish market.[2] With almost forty million people, modest economic growth in 1992, and no ethnic tensions of the type that threaten stability in many other central and eastern European countries, Poland should be in a position to attract international commercial lenders to help finance its economic development.[3] Poland's recently earned reputation for having the fastest growing European economy in 1993 should also help it to attract foreign investment.[4]

The legal protection available to creditors will be an important consideration in a foreign bank's decision of whether to enter the Polish banking market. In most commercial financing transactions, lenders prefer to make secured loans. A bank's ability to rely on clear, predictable, and easily enforceable rules in securing its credits is a nec-

1. *See* Anthony Robinson, *Sell-Offs Gather Pace*, FIN. TIMES, June 17, 1993, at VIII.
2. Ryszard Tupin et al., *Ready for Reform*, CENT. EUROPEAN, Feb. 1992, at 26, 28.
3. *See Poland's Economic Reforms: If it Works, You've Fixed It*, ECONOMIST, Jan. 23, 1993, at 21-23.
4. *Off to the Polls*, ECONOMIST, Sept. 18, 1993, at 54, 56.

essary condition of comprehensive, large-scale lending activities in Central and Eastern Europe.[5] Unfortunately, the Polish laws regulating secured transactions do not offer banks the same degree of security as is offered in the West.[6]

Until now, Poland has followed a piecemeal approach towards reforming its legal system. Poland has enacted a myriad of new statutes and amendments intended to eliminate some of the most restrictive provisions of the old Civil Code, Code of Civil Procedure, and other basic laws. As a result, in order to get an overview of the Polish regulations pertinent to secured transactions, one must consult many statutes and ordinances. Although banks may structure their lending practices to minimize their risks, it is undesirable that they must first master a complex web of laws and regulations that contain many potential pitfalls.[7]

Recognizing the need for a comprehensive overhaul of the regulations governing secured transactions, the Civil Law Reform Commission, operating under the aegis of the Ministry of Justice, selected the Working Group on Reforming the Rules on Secured Transactions (Working Group) to draft new secured transactions laws.[8] The Working Group has prepared drafts of new laws, but it is uncertain when they will be enacted into law by the parliament.[9]

This Note discusses the current regulation of secured transactions in Poland. Following a brief historical sketch of the Roman roots of the Polish approach to secured transactions, this Note describes those rules in the Civil Code, Code of Civil Procedure, and the Law on Land Registers and Mortgages that regulate creation and enforcement of security interests in immovable and movable property.[10] This Note identifies the most antiquated rules impeding widespread use of se-

5. *Cf.* Pavel Holec et al., *Secured Lenders Face Uncertainty Under New Czechoslovak Rules*, INT'L FIN. L. REV., June 1992, at 34; *see also* William B. Simons, *New Russian Legislation on Secured Translations*, 18 REV. CENT. & E. EURO. L. 571, 571 (1992).

6. *See Full of Western Promise?*, INT'L CORP. L., June 1993, at 27.

7. Moreover, some of the secured financing techniques available in the West are simply not available under current Polish laws.

8. Interview with Dr. Tomasz Stawecki, Secretary of the Working Group on Reforming the Rules on Secured Transactions, in Warsaw, Poland (Dec. 28, 1992).

9. *Id.* The European Bank for Reconstruction and Development has prepared a draft of a model law on secured transactions for countries where the bank operates, including Poland, but its draft has not been a major factor in the considerations of the Working Group. *Id.*

10. The common law distinction between real and personal property has its civil law counterpart in the distinction between immovable and movable property. Contractual rights and other transferable claims are designated as incorporeal property.

cured transactions and describes and evaluates changes to the existing laws and the new laws proposed by the Working Group of the Civil Law Reform Commission. In order to illustrate areas where the Polish regulations are especially inadequate, this Note makes occasional comparison to the Uniform Commercial Code (U.C.C.).

II. THE ROLE OF SECURED TRANSACTIONS IN THE POLISH CIVIL LAW SYSTEM

A. *The Civil Law Concept of Secured Transactions*

The civilian concept of real security is that the debtor grants the creditor ownership, possession, or a limited right (*ius in re aliena*) in the debtor's property, which serves as security for the debt. Real security differs from personal security, such as suretyship or guarantee, which is based on a purely contractual obligation of the debtor to repay the loan. A security interest gives the creditor, as a secured party, priority over the debtor's personal creditors. The creditor may seek satisfaction for a credit up to the amount of the value of the property encumbered.

Poland is a civil law country, and the roots of Polish laws on secured transactions are in Roman law.[11] Since there are important conceptual differences between the civil and common law approaches to property rights, a brief discussion of the principles of civil property law is warranted.

In contrast to the common law, Roman law developed the concept that an owner has absolute title to the property. "In Roman law a holder had title or had not."[12] In civil law countries, ownership vests the best title in the property and gives the owner a right to maintain his ownership against all the world. The right of ownership is indivisible and incapable of being classified into varying degrees.[13] There is no such thing as a descending scale of ownership rights.

The right of ownership is distinguishable from limited rights *in re*.[14] Limited property rights invest their holder with rights in somebody else's property (*jura in re aliena*).[15] Consequently, the actual

11. *See* Aleksander W. Rudziński, *A Comparative Study of Polish Property Law*, *in* 1 POLISH CIVIL LAW 57, 68-69, 103 (D. Lasok ed., 1973).

12. K.W. RYAN, AN INTRODUCTION TO THE CIVIL LAW 158 (1962).

13. Rudziński, *supra* note 11, at 60.

14. Rights *in re* give the holder a claim to assert his right against the world and grant him remedies against all who infringe upon this right. The English term for "rights *in re*" is "rights in rem."

15. Rudziński, *supra* note 11, at 60.

owner of the property charged with a limited property right for the benefit of another is restricted in his prerogative to deal with the property as he pleases.

Roman law classified the limited rights *in re* into personal servitudes, real servitudes, and security interests.[16] Taking security for a loan was common in ancient Rome, and three types of real security were developed.[17] The first to develop was *fiducia*. *Fiducia* required the transfer of ownership to the creditor.[18] This transfer had important consequences for the relative positions of the creditor and the debtor, with the former enjoying a significant level of protection, including a right to sell the collateral upon default. The position of the debtor, on the other hand, was weak; since he relinquished his ownership, the debtor could not establish a second encumbrance on the property and had to rely on retransfer when the debt was paid. However, the debtor was usually allowed to retain possession of the collateral.[19]

Fiducia was eventually replaced by *pignus*, which gave the creditor actual possession of the collateral but not its ownership.[20] Upon repayment of the debt, the pledgor's interest was protected by *rei vindicatio*, an action available to the owner to reclaim his ownership.[21] In case of default, the creditor could sell the collateral, but only if the contract between the parties so provided. Since the creditor's limited property right was conceptualized as *ius in re aliena*, the secured party could not dispose of the collateral short of a specific contractual proviso.[22]

Hypotheca was the final and most advanced type of a real security interest developed by the Romans. It gave the debtor both ownership and possession of the collateral and authorized the creditor to take

16. RYAN, *supra* note 12, at 178.

17. ALAN WATSON, ROMAN AND COMPARATIVE LAW 50-51 (1991). For a detailed study of real security in Roman Law, see Roger J. Goebel, *Reconstructing the Roman Law of Real Security*, 36 TUL. L. REV. 29 (1961-62).

18. WATSON, *supra* note 17, at 50.

19. *Id.* at 51.

20. REINHARD ZIMMERMANN, THE LAW OF OBLIGATIONS: ROMAN FOUNDATIONS OF THE CIVILIAN TRADITION 220-21 (1990). Turning possession over to the creditor was required in early and post-classical periods of Roman law. During the classical period, a pledge could have been created even though the pledged property remained with the pledgor. *See generally* Goebel, *supra* note 17, at 34, 35-40.

21. ZIMMERMANN, *supra* note 20, at 221. *Rei vindicatio* could have been used to reclaim the object not only from the pledgee, but also from any third party. The claimant must have proved to the court his ownership of the object. *Id.*

22. *Id.* at 223-25.

possession only upon default.[23] For the debtor, it was the most advantageous form of limited property right. It gave him both the use of the collateral and the ability to encumber it with additional limited property rights. In case of default, the prior creditor had priority over the later creditor in satisfying his loans.[24]

Roman real security concepts permeate the laws on real security in civil law countries. The common characteristic of these laws is that a catalog of limited rights *in re* is strictly defined by statutes. The statutes contain an exhaustive enumeration of rights *in re* and generally prohibit parties from contractually expanding the scope of rights as provided for by the legislatures (*numerus clausus*).[25] Also, the statutes define the scope of each right and determine its nature and content. Although the specific content of the limited property right can be modified, parties may do so only to the extent permitted by statute.[26]

The pledge is the most prominent real security among the *numerus clausus* of limited property rights in movable property. Its roots are in the Roman *pignus*. The pledge requires a contract between the owner and the creditor and a delivery of possession to the creditor.[27] The delivery requirement is a serious obstacle in commercial secured transactions because debtors often need to use the collateral in order to generate income required to repay the loan. The French legislature has solved this problem by passing statutes providing for nonpossessory security interests in the form of equipment liens.[28] The German law followed a different path.[29] It developed a fiduciary transfer of title under which the debtor may remain in the actual possession of the collateral.[30]

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23. WATSON, *supra* note 17, at 185.

24. *Id.* at 51-52.

25. *See* RYAN, *supra* note 12, at 144-47.

26. *Id.* at 144.

27. *Id.* at 185.

28. *See* Stephan H. Haimo, *A Practical Guide to Secured Transactions in France*, 58 TUL. L. REV. 1163, 1169-73 (1984); *see also* Antoine Fourment, *Forms of Security Interests in Movable Property and Receivables Which Exist in France*, *in* SECURITY ON MOVABLE PROPERTY AND RECEIVABLES IN EUROPE 37, 42-46 (Michael G. Dickson et al. eds., 1988).

29. *See* Wolfgang Rosener, *Federal Republic of Germany*, *in* SECURITY ON MOVABLE PROPERTY AND RECEIVABLES IN EUROPE, *supra* note 28, at 58, 62-65; U. Drobnig, *Security over Corporeal Movables in Germany*, *in* SECURITY OVER CORPOREAL MOVABLES 181, 197-99 (J.G. Sauveplanne ed., 1974).

30. Rosener, *Federal Republic of Germany*, *supra* note 29, at 62-64.

The civilian concept of a security interest in real property is based on Roman *hypotheca*.[31] Consequently, debtors retain ownership and possession of the property but grant creditors a limited property right that gives the creditors, upon default, a priority in recovering their credits from the proceeds of the sale of the charged real property. In civil law countries, creditors only have a right to demand the judicial sale of the property, and they will be repaid from its proceeds. Unlike a common law mortgagee, a civil law real property creditor does not have a right to foreclose or enter into possession of the charged real property.[32]

B. The Development of Polish Law on Secured Transactions

As noted above, the roots of Polish civil law, including the property law and the rules on secured transactions, are in the Roman legal tradition.[33] The Roman concepts came to Poland via the Code of Napoleon, the German B.G.B., and the Austrian A.B.G.B., which were laws of the land in Polish territories occupied by the Russians, Prussians, and Austrians throughout the nineteenth and the early years of the twentieth centuries.[34] Soon after Poland regained its statehood in 1918, a special Codification Commission was entrusted with the task of preparing drafts of comprehensive codes and laws.[35] The Commission prepared, and the President of Poland promulgated, the Code of Obligations (1933) and the Commercial Code (1934).[36] Because World War II prevented the President from enacting the Law on Property and the Law on Mortgages, these laws were not enacted until 1946.[37]

Pledge and mortgage were the backbones of real security in pre-World War II Poland. Still, the pre-war capitalist economy required more flexible forms of security interests in movables than the posses-

31. *See* Ryan, *supra* note 12, at 186, 188.

32. *Id.* at 191-92. At one point in the development of the Roman law, the creditor was entitled to take over the ownership and possession of the collateral upon the debtor's default. In response to frequent abuses by the creditors, Emperor Constantine prohibited the use of forfeiture clauses in *hypotheca* agreements. *See generally* Goebel, *supra* note 17, at 51.

33. Rudziński, *supra* note 11, at 103.

34. *See* Wacław W. Soroka, *The Law in the Polish Lands During the Partition Period, in* POLISH LAW THROUGHOUT THE AGES 119, 124-25 (Wenceslas J. Wagner ed., 1970).

35. Bronisław Hełczynski, *The Law in the Reborn State, in* POLISH LAW THROUGHOUT THE AGES, *supra* note 34, at 139, 141.

36. *Id.* at 142, 144.

37. Vincent C. Chrypiński, *Postwar Developments in Polish Law, in* POLISH LAW THROUGHOUT THE AGES, *supra* note 34, at 177, 185-86.

sory pledge. Following the French example, Poland passed statutes providing for nonpossessory security interests in agricultural crops, cut timber, motor vehicles, and machines and appliances.[38]

Moreover, the Commercial Code provided for commercial pledges between merchants.[39] A commercial pledge could have been created on movables, negotiable instruments, and certificated securities. It significantly strengthened the creditor's position by giving him the right of extrajudicial enforcement in case of default.[40] When the debtor did not cure the default within two weeks of the creditor's demand, the secured party had the right to sell the collateral at a public auction.[41]

This relatively well-developed system of laws on secured transactions came to an end in 1964. That year the parliament passed a comprehensive Civil Code which superseded the 1933 Code of Obligations and the 1946 Law on Property. The Civil Code authorized six limited property rights: perpetual usufruct, usufruct, servitude, pledge, mortgage, and a cooperative right to an apartment.[42]

Two of the above, pledge and mortgage, are of interest here. Although the Civil Code includes provisions for pledges, it does not regulate mortgages. This omission was intended and dictated by ideological premises. It was then believed that mortgages were a quintessential institution of a capitalist economy, and thus unworthy of being introduced into a socialist Civil Code.[43] Nonpossessory pledges on agricultural crops, cut timber, motor vehicles, and machines and appliances were eliminated for similar reasons, as were the provisions of the Commercial Code pertaining to commercial pledges.[44] With the

38. *See* Rudziński, *supra* note 11, at 104.

39. Rozporządzenie Prezydenta Rzeczypospolitej z dnia 27 czerwca 1934 r.—Kodeks handlowy [Ordinance of the President of the Republic from June 27, 1934—Commercial Code], 1934 Dz.U., no. 57, item 502, art. 507 [COM. CODE]. The Commercial Code has since been amended many times.

40. *Id.* arts. 509-13; *see also* STANISŁAW JANCZEWSKI, PRAWO HANDLOWE, WEKSLOWE I CZEKOWE [Law of Corporations and Negotiable Instruments] 296-301 (1946).

41. JANCZEWSKI, *supra* note 40, at 298.

42. *Ustawa z dnia 23 kwietnia 1964 r.—Kodeks cywilny* [Law of April 23, 1964—Civil Code], 1964 Dz.U., no. 16, item 93, arts. 232, 244 [CIV. CODE]. The Civil Code has since been amended many times.

43. STANISŁAW SOŁTYSIŃSKI, *O potrzebie wprowadzenia nowych form zabezpieczania kredytu gospodarczego*, [A Call for New Forms of Secured Transactions], 1271 PRACE NAUKOWE UNIWERSYTETU ŚLĄSKIEGO: PRACE PRAWNICZE WYDANE DLA UCZCZENIA PRACY NAUKOWEJ KAROLA GANDORA 173, (1992).

44. *Ustawa z dnia 23 kwietnia 1964 r.—przepisy wprowadzające kodeks cywilny* [Law of April 23, 1964—Law Introducing the Civil Code], 1964 Dz.U., no. 16, item 94, arts. V, VI.

1982 Law on Land Register and Mortgages replacing the 1946 statute, mortgages continue to be regulated outside the Civil Code.[45]

III. CURRENT REGULATION OF SECURITY INTERESTS IN REAL PROPERTY

A. *The Nature of a Mortgage Under Polish Law*

Polish law recognizes a mortgage as a security of a particular piece of real property for payment of a debt.[46] Thus, the creation of a mortgage requires the existence of a principal monetary obligation to which the mortgage accedes. As an ancillary property right, a mortgage will be enforceable only if the principal monetary obligation is valid and enforceable. A corollary of this principle of accession is that the repayment of the underlying monetary obligation extinguishes the mortgage. On the other hand, the debt does not have to be related to the mortgaged property.[47] Nor is there a requirement for the mortgaged realty to be the property of the actual borrower.[48] A mortgage can be created for the benefit of a borrower who is not an owner of an encumbered realty.

Privately owned real property can be freely mortgaged.[49] Yet, foreigners cannot acquire ownership of real property in Poland without obtaining prior permission from the Minister of Internal Affairs.[50] Clearly then, creation of a mortgage as security for credit extended by a foreign natural person or a foreign legal entity is subject to uncertainty, namely whether the Ministry will grant the permit in the event of default when the creditor desires to acquire ownership of the collateral.

The mortgage attaches to the real property and secures a claim to such property regardless of possible subsequent changes in its ownership.[51] Any provision against future encumbrance and transfer is void.[52] Establishing a mortgage requires a bilateral contract, a mort-

45. *Ustawa z dnia 6 lipca 1982 r. o księgach wieczystych i hipotece* [Law of July 6, 1982—Law on Land Register and Mortgages], 1982 Dz.U., no. 19, item 147 [hereinafter Law on Mortgages].

46. *Id.* art. 68.

47. MAŁGORZATA BEDNAREK ET AL., HIPOTEKA [Mortgages] 29-30 (1992).

48. *Id.*

49. Law on Mortgages, art. 65.

50. *Ustawa z dnia 24 marca 1920 o nabywaniu nieruchomości przez cudzoziemców* [Law of March 24, 1920 on Acquisition of Immovable Property by Foreigners], 1933 Dz.U., no. 24, item 202, *as amended by* 1988 Dz.U., no 41, item 325.

51. Law on Mortgages, art. 65, § 1.

52. *Id.* art. 72.

gage deed acknowledged by the notary, and registration of the mortgage in the appropriate land and mortgage register.[53] Until 1991, the registers were maintained by notaries. The February 1991 amendments to the 1982 Law on Land Register and Mortgages transferred this responsibility to the common courts.[54]

The concept of a mortgage in the Polish law has its roots in Roman *hypotheca*. This is exemplified by the principle that granting a mortgage to one party does not take away from the owner of the real property his right to further encumber the property or to transfer its ownership to a third party.[55] The parties to the mortgage contract are not at liberty to deviate from this statutory provision. Nevertheless, if the owner of the mortgaged property, or any other party, takes legal action that may seriously diminish the mortgagee's security, the mortgagee can demand that the mortgagor halt any such acts. If the mortgagor ignores the mortgagee's demands, the latter has a cause of action in the civil court for declaring the harmful acts void against the mortgagee.[56]

A mortgage can be established over an entire real property owned by a debtor, over a portion of such real property expressed as a fraction, and over a right of perpetual usufruct.[57] The October 1991 Act amending the Civil Code and the Law on Land Registers and Mortgages has enabled some 1.5 million individuals holding so called "cooperative rights to property" to mortgage their apartments to secure consumer, and possibly small commercial, loans.[58]

The basic form of the contractual mortgage requires the debt to be expressed in a determined sum of money.[59] The prevailing view, reflecting an interpretation of article 358 of the Civil Code, is that a

53. Civ. Code art. 245, § 1; Law on Mortgages, art. 32, § 1, art. 67, § 1.

54. *Ustawa z dnia 25 października 1991 r. o zmianie ustawy—Kodeks cywilny oraz ustaw—O księgach wieczystych i hipotece, Prawo spółdzielcze, Kodeks postępowania cywilnego, Prawo lokalowe* [Law Amending the Law on Land Register and Mortgages, Law on Cooperatives, Code of Civil Procedure, Tenant Law], 1991 Dz.U., no. 115, item 496, art. 24 [hereinafter Amendments to the Law on Mortgages].

55. Law on Mortgages, art. 72. In other words, Poland follows what the common law calls a lien theory of mortgage.

56. Civ. Code art. 527.

57. Law on Mortgages, art. 65. Perpetual usufruct is a renewable right to use state-owned land for a period of ninety-nine years. This right is transferable but the land remains state property following a transfer. Buildings and other structures erected on the land by usufructuaries become their property and they may transfer title to them together with their right to use the land.

58. Amendments to the Law on Mortgages, art. 2(4).

59. Law on Mortgages, art. 68.

debt should be denominated in Polish currency (*złoty*) only.[60] This does not mean that the banks must actually lend in Polish currency. Lending in foreign currency is expressly authorized by the Banking Law.[61] Banks that issue loans in a foreign currency can protect themselves from the fluctuations of the *złoty* by taking advantage of a special type of mortgage to cover future debts (*hipoteka kaucyjna*).[62] *Hipoteka kaucyjna* is used when the specific amounts are not known or cannot be calculated at the time of contracting. To be enforceable, a mortgage contract must specifically describe an underlying legal relationship from which the future debt will flow as well as describe the property to be mortgaged. In addition, an agreement must put a ceiling on the amount of debt to be secured.

Only in very limited circumstances does Polish law provide for one mortgage contract to encumber all individual pieces of real estate owned by the borrower. The so called joint mortgage (*hipoteka łączna*) gives the mortgagee, upon the mortgagor's default, the flexibility of selecting the property or properties to be used for the satisfaction of the debt.[63] Because of this flexibility, the joint mortgage is regarded by lenders as one of the most secure forms of credit. Unfortunately, Polish law provides for joint mortgages only when real property that is held in cotenancy and already burdened by the mortgage is partitioned into separately held units.[64] In this case, all individual units that result from the partition are deemed to be equally burdened with a mortgage. In the case of single ownership of several separate realties, the same result can be achieved only by separately mortgaging all individual properties belonging to the mortgagor. Of course, this would require several mortgage contracts and would result in higher legal and notarial fees.

B. Creation of a Mortgage

Creation of a mortgage requires three distinct steps. First, the future mortgagee and mortgagor must enter into a bilateral contract.[65] The contract should identify the parties, unequivocally declare the

60. *See* IZABELLA HERAPOLITAŃSKA & ELŻBIETA BOROWSKA, KREDYTY I GWARANCJE BANKOWE [Bank's Credits and Guarantees] 156 (1992).

61. *Ustawa z dnia 31 stycznia 1989 r.—Prawo bankowe* [Law of January 31, 1989—Banking Law], 1989 Dz.U., no. 4, item 21, art. 25 [hereinafter Banking Law]. The Banking Law has since been amended at least six times.

62. *See* Law on Mortgages, arts. 102-08.

63. BEDNAREK et al., *supra* note 47, at 65.

64. Law on Mortgages, art. 76, § 1.

65. CIV. CODE art. 245, § 1.

property owner's intention to grant a mortgage, and identify the debt and the real property that serve as security for the repayment of the debt.[66] To complete the mortgage contract, the mortgagor must reaffirm in the presence of the notary an intent to encumber the real property with a mortgage. The mortgagor's declaration must be in the form of a notarial deed.[67] When a mortgage is granted to a bank, including a Polish subsidiary of a foreign bank, an entry of a mortgage contract in the bank's register disposes of the requirement of a notarial deed.[68]

Second, the mortgagor must make a motion for entry of the mortgage in the land register. The notary is statutorily obliged to make sure that such a motion is a part of the contract.[69]

Third, the appropriate court must enter the mortgage in the land register. The mortgage is deemed created only at the time of such entry.[70] Nonetheless, among competing mortgages, priority is determined not from the time of the actual entry but at the time the motion was received.[71] If the motions were received on the same day, mortgages receive the same priority.[72]

Land registers are open to public inspection.[73] An entry on the register implies constructive knowledge by the rest of the world.[74] All property rights to real property, and a very small category of contractual rights and obligations, are subject to entry.[75] In order to provide for a stable real estate market, the law presumes that all data in the public register is correct and up to date.[76] This means that a good faith purchaser for value is protected against any claims by a third party.

The process of mortgage creation functions well and there are no significant delays. Notaries are licensed lawyers admitted to the profession by the Minister of Justice. They operate private notary practices and compete for clients.[77]

66. BEDNAREK et al., *supra* note 47, at 78-79.
67. Law on Mortgages, art. 31, § 1, art. 33.
68. Banking Law, art. 50, § 1.
69. Law on Mortgages, art. 39.
70. *Id.* art. 67, § 1.
71. *Id.* arts. 12, 29; *see also* HERAPOLITAŃSKA & BOROWSKA, *supra* note 60, at 156.
72. Law on Mortgages, art. 12, § 1.
73. *Id.* art. 2.
74. *Id.* art. 5.
75. *Id.* art. 16.
76. *Id.* art. 3. This is known as the rule of public faith of the land register.
77. Notaries charge for their services in accordance with a scale issued by the Minister of Justice. According to the scale of April 12, 1991, when the mortgaged amount exceeds

C. *Enforcement*

The Law on Land Register and Mortgages envisions the judicial execution proceeding as the exclusive means of mortgage enforcement.[78] The civil court in the area where the property is located has subject matter jurisdiction over mortgage enforcement claims.[79]

Execution encompasses three distinct phases, resulting in an unnecessarily complex and time-consuming process. A mortgagee must first obtain an executory title (*tytuł egzekucyjny*), typically a civil court judgment against the mortgagor.[80] The mortgagee must then apply for an enforcement title (*tytuł wykonawczy*) which entails the court placing a seal, called an enforcement clause (*klauzula wykonalności*), upon the executory title and the judge signing it. Thus, the enforcement title is an official court document signed and sealed by a judge.[81] The execution order is then forwarded to the court's execution officer (*komornik*) with the instruction to make a final demand for payment and to take over the property.

If the mortgagor does not pay within two weeks, the execution officer hires court-approved experts to prepare a description and an appraisal of the real estate.[82] Both the description and the appraisal are subject to legal challenge by the mortgagor.[83] If the mortgagor fails in these challenges, the property is offered for sale at the public auction. The initial bidding price during the first auction is seventy-five percent of the valuation price.[84] It drops to two-thirds of the valuation price if a second auction is required.[85] Only when the property is not sold during the second auction can the mortgagee purchase the property at a private sale, paying at least two-thirds of the valuation price.[86] If he does not exercise this right, the execution is terminated.

$31,000 the fee is approximately $500 plus 0.5% of the amount in excess of $31,000. The fee then increases progressively, but cannot exceed approximately $3,100. In addition to the notary fee, a stamp fee of 0.1% and a court filing fee of 1.6% of the amount of the mortgage must be paid. In Polish banking practice it is the borrower who traditionally pays all expenses incurred in mortgaging real estate. *See* BEDNAREK et al., *supra* note 47, at 98.

78. Law on Mortgages, art. 75.

79. *Ustawa z dnia 17 listopada 1964 r.—Kodeks postępowania cywilnego* [Law of November 17, 1964—Code of Civil Procedure], 1964 Dz.U., no. 43, item 296, art. 38, § 1 [CIV. PROC. CODE]. The Code of Civil Procedure has since been amended many times.

80. *Id.* art. 777.

81. *Id.* art. 776.

82. *Id.* arts. 942, 948.

83. *Id.* art. 950.

84. *Id.* art. 965.

85. *Id.* art. 983.

86. *Id.* art. 984.

The mortgagee cannot make a motion to the court for a new execution procedure until twelve months after the last failed attempt.[87]

The parties may considerably streamline the execution procedure by incorporating into their mortgage contract clear terms of repayment of the debt and an unequivocal statement by the mortgagor in which he agrees to an execution from a mortgaged property in case the mortgagor fails to pay as stipulated.[88] When incorporated in the notarized mortgage deed, such a statement functions as the equivalent of an executory title and as a basis for the court to issue the necessary enforcement title.[89] Upon the debtor's default and lack of response to the secured party's demands for payment, the secured party is entitled to have the executory title sealed and signed by the judge. With the seal so added, the executory title is transformed into an enforcement title that serves as the basis for the court execution officer to take possession of the collateral. In short, having the debtor agree to an execution from the collateral in a notarial deed enables the creditor to avoid litigation otherwise required to obtain the executory title. It is important to note that in the case of banks, the official excerpts from bank registers constitute enforcement titles without the court seal and judge's signature, which are otherwise required.[90]

A successful sale of real property at an auction does not always result in a secured creditor recovering his loan. Under article 1025 of the Code of Civil Procedure (C.C.P.), the mortgage creditor's claim is preceded by several special priority claims, including claims for the costs of execution, alimony payments owed by the debtor, employee wages and certain other benefits, costs of the last medical treatment and eventual funeral expenses of the debtor, taxes owed by the debtor, and bank credits made available to the debtor. It is remarkable that bank credits, even if unsecured, come before creditors' claims that are secured by a mortgage. This provision is one of the most revealing examples of preferential treatment extended by the former communist regime to the nationalized sector of the economy. Of course, all banks were state-owned or state-controlled when article 1025 came into existence in 1964.

87. *Id.* art. 985.

88. *Id.* art. 777, § 4.

89. Banks can also use a shortcut in the execution process. If a debtor signs a statement confirming his indebtedness and specifying the maturity date, such a statement will be treated as an executory title upon default. *See Równouprawnienie w postępowaniu egzekucyjnym,* [Equal Rights in Execution Process] RZECZPOSPOLITA, July 29, 1993, at 18.

90. *Id.*

The above order of priority also applies in the case of bankruptcy of the debtor. Article 118 of the 1934 Bankruptcy Law provides that in event of bankruptcy, the priority rules of the Code of Civil Procedure apply to any debts secured by a mortgage.[91] Although a secured creditor's claim is adjudicated separately from those of unsecured creditors, the aforementioned claims listed in the Code of Civil Procedure are still given preference. In case the proceeds from the sale of the mortgaged property—after satisfying all higher claims—are not sufficient to fully repay the debt, the creditor may seek repayment of the debt from other items of the bankruptcy estate.[92] However, the bankruptcy law gives low priority to a creditor's claims. Costs of bankruptcy proceedings, bankruptcy trustee, tax, and any other public debts and social security dues all come before secured creditors' claims.[93]

Clearly, forfeiture clauses in mortgage contracts are not allowed and contracting parties cannot deviate from this statutory restriction. There are no exceptions from the judicial execution procedure, and no special provisions simplifying enforcement of mortgages granted by one commercial entity to another are allowed.[94]

IV. CURRENT REGULATION OF SECURITY INTERESTS IN MOVABLES

The pledge is the cornerstone of the Polish system of security in items other than real property. The Civil Code provides for pledges on existing movables, future or conditional receivables, and transferable rights. The pledgee has priority up to the amount of the value of the property charged over the debtor's personal creditors in seeking satisfaction of a credit he extended to the pledgor.[95] Unless the pledgee is a bank, a security interest in the movable property can be created only as a possessory pledge.

Under Polish law, only an owner can encumber his property with a pledge.[96] In contrast, the requirement of ownership does not exist

91. *Rozporządzenie Prezydenta Rzeczypospolitej z dnia 24 października 1934 r.—Prawo upadłościowe* [Ordinance of the President of the Republic of Poland of October 24, 1934—Bankruptcy Law], Dz.U. 34 no. 93, item 834 [hereinafter Bankruptcy Law]. The Bankruptcy Law has since been amended many times.

92. *Id.* art. 207.

93. *Id.* art. 203; *see also* FELIKS ZEDLER, PRAWO UPADŁOŚCIOWE W ZARYSIE [Outline of Bankruptcy Law] 66-67 (1992).

94. *Compare* Holec, *supra* note 5, at 35.

95. CIV. CODE art. 306.

96. *Id.* art. 307.

under the U.C.C. Instead, the U.C.C. only requires that the debtor have rights in the goods he intends to use as collateral.[97] The ability under the U.C.C. to create security interests by persons other than the legal owner is an important difference from Polish law governing pledges. Polish law, which requires a contract between the owner and the pledgee, thus limits the category of persons who may use the pledges as a means to obtain credit.

A. Possessory Pledges

A possessory pledge (*zastaw posesoryjny*) is regulated by articles 306-326 of the Civil Code and is based on the Roman concept of *pignus*. Possessory pledge is available to secure both repayment of monetary debts and performance of other obligations. In order to create an enforceable possessory pledge on movable property, the creditor and the owner must enter into a contract after which the property must be delivered into possession of the creditor or an agreed third party.[98] The pledge is effectively created at the time of the actual transfer of the collateral.

The creation of a possessory pledge under the Polish Civil Code fundamentally differs from the creation of a security interest under the U.C.C. Polish law does not recognize the distinction between attachment and perfection of a security interest. Under the U.C.C., an attachment occurs when the debtor signs a security agreement that contains a description of the collateral or when the secured party has taken possession of the collateral as in a pledge.[99] Attachment creates an enforceable security interest as against the debtor (*i.e.*, once the security interest has attached, a secured party can realize the collateral against the debtor).[100]

Perfection of the security interest normally is necessary to make the security interest effective against third parties, such as other credi-

97. U.C.C. § 9-203(c) (1977). Unfortunately, the U.C.C. does not define the term "rights." It is clear that the owner has the requisite rights in the collateral. On the other hand, courts have held that naked possession does not in itself grant the possessor the requisite rights. *See* Kinetics Technology Int'l Co. v. Fourth Nat'l Bank of Tulsa, 705 F.2d 396, 399 (10th Cir. 1983). Thus, the debtor's right in the collateral must be more than naked possession in order for him to use the goods as collateral, although the right does not have to reach full legal ownership. One category of such persons includes a person with a voidable title (*e.g.*, a merchant who in good faith received possession of stolen goods). *See* U.C.C. § 2-403(1). Another category includes a debtor in possession of goods of another endowed with the power to transform the goods. *Kinetics*, 705 F.2d at 398-400.

98. CIV. CODE art. 307.

99. U.C.C. § 9-203(1)(a).

100. *Id.* § 9-203(2).

tors or persons to whom the collateral is transferred. A security interest is perfected when it has attached (*e.g.*, a debtor and the secured party have entered into a written security agreement, or the secured party has taken possession of the collateral) and when "all of the applicable steps required for perfection have been taken."[101] These steps refer to some action by the secured party calculated to give notice of the security interest to third parties. The U.C.C. provides for two principal methods of perfection: turning over possession of the collateral to the secured party or filing a notice of the existence of a security interest in a designated public office.[102]

Consequently, while under the U.C.C. it is possible to create a security interest that will be enforceable only against the debtor (*e.g.*, attachment took place, but no perfection followed), such a result is impossible under Polish law. Under the Polish Civil Code, possession must occur. A pledge contract not followed by giving the pledgee possession of the collateral does not have any legal effect and is unenforceable even against the pledgor.

A corollary to the requirement of transferring possession under Polish law is that the pledge expires if the pledgee or a third party returns the movable property to the pledgor.[103] However, at least in principle, the transfer of ownership of the charged item by the pledgor does not affect the validity of the pledge, which continues to be attached and perfected regardless of the change in ownership. Furthermore, any contractual restriction on the pledgor's right to further encumber or transfer the object of the pledge is void.[104]

Like the mortgage, the pledge is an ancillary property right, which cannot come into being without the existence of an underlying debt or obligation.[105] Consequently, pledged collateral is transferable only in conjunction with the transfer of debts or other claims it secures.[106] If a claim to a debt or obligation is transferred but the collateral remains with the pledgee, the pledge expires.[107]

A transfer of both a secured claim and possession of a collateral poses a question regarding the effect of such transfer on the priority of

101. *Id.* § 9-303.
102. *Id.*
103. CIV. CODE art. 325.
104. *Id.* art. 311.
105. *See* JERZY IGNATOWICZ, PRAWO RZECZOWE [Law of Property] 262 (1979). Unlike the mortgage, which can secure monetary claims only, the pledge can secure both monetary and other obligations. *Id.* at 265.
106. CIV. CODE art. 323, § 1.
107. *Id.* art. 323, § 2.

pledges. Since article 323 of the Civil Code addresses the transfer of the existing secured claims, it is likely that there is no new pledge created and the date of the delivery of the collateral to the original pledgee remains the creation date for the transferred claim. This may have important consequences in some situations, for example, when a court determines the priority of claims in a bankruptcy proceeding.

In several circumstances, pledges arise by operation of law. The Civil Code provides for the following statutory pledges: (a) by the lessor over the lessee's movables brought onto leased property; (b) by the tenant renting movables that aid in conducting farming activities or an enterprise's business over the movables located on the leased property; (c) by the agent over movables received in connection with an agency contract; (d) by the commission agent over commission sale items; (e) by the carrier over shipments; and (f) by the warehouse over goods accepted for storage.[108]

Separate regulations apply to pledges on ships.[109] When a ship is entered into a ship register, it is treated as real property, and the rules regulating mortgages apply accordingly. If, on the other hand, the ship has not been registered, it is treated as a movable, and the rules on pledges apply. Regardless of this distinction, the Maritime Code allows for possessory as well as nonpossessory pledges on non-registered ships.[110]

B. Nonpossessory Pledges

The requirement of turning over physical possession of collateral to a pledgee severely limits the use of possessory pledges as a means of securing commercial credit. In a purely commercial context, possessory pledges are usually impractical given the debtor's need to use and dispose of the collateral in order to repay the credit. Recognizing the limited suitability of possessory pledges for commercial lending, article 308 of the Civil Code authorizes banks to obtain security without taking actual possession of the collateral (*zastaw rejstrowy*).[111] Under this article, the property may remain in the possession of the debtor or a third party. The scope of this provision was previously

108. *Id.* arts. 670, 701, 764, 773, 790, 802, 857.

109. *See* Kodeks Morski [MARITIME CODE] 1961 Dz.U., no. 58, item 318, arts. 64, 65. There are no special rules regulating security interests in airplanes.

110. *Id.*

111. CIV. CODE art. 308, § 1.

limited to Polish state-owned banks.[112] However, amendments to the Civil Code and the new Banking Law have expanded the entities authorized to secure their credits by nonpossessory security interests to include all banks operating in Poland, including Polish subsidiaries of foreign financial institutions.[113]

1. Creation of Nonpossessory Pledges

The Civil Code treats nonpossessory security interests as a special type of traditional pledge.[114] There are three requirements for establishing an enforceable nonpossessory pledge. First, any contract for such a pledge must be in writing.[115] Second, the contract for the security interest must be entered into a bank register, and it is deemed created from the moment of registration.[116] Finally, a contract for a nonpossessory pledge on movables "shall define the object of the pledge in the manner corresponding to its characteristics."[117]

In order to understand the third requirement, it is necessary to note that Polish Civil Law distinguishes between movables possessing unique, individual characteristics *(rzeczy oznaczone co do tożsamości)* and other movables that can be only identified as belonging to a certain class of corporeals *(rzeczy oznaczone co do gatunku)*.[118] The first category includes any movable that can be individually identified (*e.g.*, a 1972 orange Volkswagen Beetle with California registration plates 183 EPK). The second category includes raw materials, supplies, semi-products, agricultural products, and other replacement assets.

There is little doubt that corporeals possessing unique individual characteristics can serve as collateral in nonpossessory pledge arrangements.[119] Yet, the requirement that the pledgor maintain the collateral in unchanged condition and not dispose of it[120] effectively

112. *See* Przemysław Szmyt, *W sprawie unowocześnienia systemu zabezpieczania kredytu bankowego* [A Call for Modernization of Transactions Securing Bank Credits], 10 BANK I KREDYT 6 (1990).

113. *See* Banking Law, arts. 2, 30, 57, § 2.

114. A literal translation of *zastaw rejstrowy* is "registrable pledge." The term "nonpossessory pledge" will be used throughout this Note to refer to a registrable pledge.

115. CIV. CODE art. 308, § 3.

116. *Id.*

117. *Id.*

118. IGNATOWICZ, *supra* note 105, at 17.

119. Józef Skąpski, *Zastaw na Rzeczach Ruchomych Według Kodeksu Cywilnego* [Pledge on Movables in the Civil Code], 8 STUDIA CYWILISTYCZNE 143, 178 (1966).

120. *See* KODEKS CYWILNY, KOMENTARZ, TOM I [Commentary on the Civil Code, Volume One] 751 (Janusz Pietrzykowski ed., 1972).

eliminates any possibility of using movables that possess unique individual characteristics for purposes of inventory financing.

The Civil Code's requirement that a contract for a nonpossessory pledge on movables define the object of the pledge in a manner corresponding to its characteristics has raised a question as to whether the nonpossessory pledge can be established on corporeals that can be identified only as belonging to a certain class of assets.[121] One view is that this question should be answered affirmatively.[122] Such interpretation would appear to open a possibility of granting security interests in replacement assets such as raw materials or inventory.

However, such a floating pledge, although similar in its general outline to an English floating charge,[123] could only be created on already existing but changing assets.[124] For such a pledge to be effective, it is important to state explicitly in the contract that the pledgor has a right to use and dispose of the raw materials or other assets being pledged subject to a condition that he will simultaneously replace them with the items of the same kind and quality.[125] The parties must also agree on the monetary value and the quantity of the replacement assets being pledged. If the above conditions are met, a pledge contract including only a general description of the replacement assets to serve as collateral may be enforced by the courts.[126] The creation of a pledge on replacement assets is subject to two important restrictions. First, it is impossible to give a security interest in nonexisting assets. The pledgor must first own a certain class of assets in order to grant a security interest in them. Thus, it is not possible to grant a security interest over after-acquired property by designating it as collateral property "now owned or hereafter acquired."[127] Furthermore, a pledge on the replacement assets must be distinguished from

121. Skąpski, *supra* note 119, at 178.

122. *Id.* at 178-80; *see also* HERAPOLITAŃSKA & BOROWSKA, *supra* note 60, at 133; Robert L. Drake, *Legal Aspects of Financing in Czechoslovakia, Hungary, and Poland*, 26 INT'L LAW. 505, 528-29 (1992).

123. For a brief introduction to English law on secured transactions, see C. Soren R. Tattam, *United Kingdom: England, in* SECURITY ON MOVABLE PROPERTY AND RECEIVABLES IN EUROPE, *supra* note 28, at 187, 195-205.

124. HERAPOLITAŃSKA & BOROWSKA, *supra* note 60, at 126.

125. Skąpski, *supra* note 119, at 179-80; *see also* HERAPOLITAŃSKA & BOROWSKA, *supra* note 60, at 133.

126. Some scholars take the view that a new pledge contract must be signed and registered in respect to each new piece of inventory or each shipment of raw materials. *See* Eugeniusz Piontek, Foreign Investment in Poland: Understanding New and Pending Regulations, at 9 (unpublished manuscript, on file with author).

127. Compare U.C.C. § 9-204, which does allow such transactions.

a pledge on the business as such. Polish law does not recognize a pledge on an existing business, and such a pledge will not be enforced by the courts.[128]

2. *Impediments to the Use of Nonpossessory Pledges*

The potentially positive effect of article 308 on secured lending has been severely limited by the lack of a centralized, universal system for registering pledges and by the inappropriate priority of secured creditors. Under the current system of registering nonpossessory pledges, the existence of the security agreement must be entered into a register of a crediting bank, and it is deemed effective from the moment of such registration.[129] The lack of a central registering system does not hinder the functioning of possessory pledges because they do not become effective until a movable is actually turned over to the pledgee. In the case of nonpossessory pledges, however, a reliable universal registering system is sine qua non for the banks to proceed with a responsible credit policy. In a country like Poland where close to 1,750 banks were in business at the end of 1991,[130] the recording of secured interests in individual bank registers is not a substitute for a centralized registration system.

The lack of a centralized system for registering security is only part of the problem. An equally serious obstacle to the widespread use of nonpossessory pledges stems from the Civil Code's rejection of the principle of "first in time, first in right."[131] Article 310 of the Civil Code provides that a later established pledge takes priority over an earlier pledge unless the subsequent pledgee acted in bad faith. Consequently, if a dishonest borrower uses the same movable to obtain a second loan, the second creditor has a superior pledge to the first creditor unless the second creditor had actual knowledge of the first security interest.

Short of affixing a conspicuous notice on the collateral, there is little the first creditor can do to give actual notice. "I've known

128. SOŁTYSIŃSKI, *supra* note 43, at 176.

129. CIV. CODE art. 308, § 3.

130. Kazimierz Szczepański, *Pożyczka i jej zabezpieczenie* [Loan and the Security for that Loan], FISKUS, June 10, 1992, at 1. Small cooperative banks dominate Polish banking industry with some 1660 banks in operation in 1991. There were also 61 Polish private banks and 11 banks owned by foreign investors or with participation of foreign investors. *Id.* For a general introduction to the Polish banking system, see Zbigniew M. Słupiński, *Foreign Investment in the Banking Sector and Emergence of the Financial Market in Poland*, 25 INT'L LAW. 127 (1991).

131. CIV. CODE art. 310.

cases," asserts a U.S. attorney practicing in Poland, "where you walked into a Polish factory and found stickers bearing a western bank's name plastered over half the machinery."[132] This is practiced because the existing entry in the first bank's books will not necessarily imply constructive notice on behalf of the subsequent pledgee and will not be sufficient in itself to imply his bad faith.[133] But affixing a notice may not be possible or practicable with some types of collateral, such as inventory in a retail store. In such situations, even a bank that did everything possible to put the rest of the world on notice regarding its security interest in given items of the collateral, can still lose against a bona fide subsequent pledgee.

The earlier creditor cannot protect himself from the undesirable consequences of article 310 by obtaining from the pledgor a contractual stipulation by which the latter promises not to further charge or dispose of the pledged object. As already discussed, article 311 of the Civil Code expressly prohibits such negative pledges. The underlying principle behind this approach is that the debtor remains the legal owner of the pledged object, and the act of pledging does not deprive him of ownership prerogatives, such as the sale of the item or its further encumbrance.[134]

Article 170 of the Civil Code undermines the protection of the pledgee even further by providing that in case of ownership transfer of collateral, the security interest in the collateral expires at the moment of the delivery of the collateral to the buyer. Only when the buyer acts in bad faith can the secured creditor prevail against the buyer. As mentioned above, due to the lack of a universal and easily accessible registration system for pledges, it is very difficult to show bad faith on the part of such a purchaser. Moreover, the Civil Code further protects the purchaser by imposing a presumption of good faith in any transaction in which the existence of good faith is material.[135]

When a pledgor consciously acts to harm the legal interests of the pledgee by disposing of his assets and when, as the result of such actions, the pledgee cannot fully recover his loans, the latter can sue

132. *Full of Western Promise?, supra* note 6, at 27.

133. Article 7 of the Civil Code establishes a presumption of good faith. In the case of a nonpossessory pledge, the presumption of good faith of the subsequent pledgee is almost impossible to overcome. No court would charge the subsequent pledgee with a duty to check the records of all banks operating in Poland and find her in bad faith if she failed to do so.

134. IGNATOWICZ, *supra* note 105, at 268.

135. CIV. CODE art. 7.

third persons who materially benefitted from the pledgor's acts.[136] The Polish version of *actio Pauliana* gives the pledgee a cause of action for rendering any such damaging transactions by the pledgor as ineffective against the pledgee.[137] Of course, this is hardly the most efficient way to protect the pledgee's interests, but it may be useful to correct the most blatant abuses by unscrupulous borrowers.[138]

In order to protect banks, the Civil Code provides that any changes or transformations of the collateral while in the possession of the pledgor do not affect the validity of the charge.[139] If, as a result of subsequent use or processing by the pledgor, the pledged property merges or becomes a part of another movable property, the pledge attaches to that other property as well.[140] To use an example given by a Polish lawyer who has written on this subject, a pledge on the picture tubes attaches to the television sets, and the purchasers of such sets buy products encumbered with the creditor's pledge.[141] The undesirable consequences of this rule in such situations are obvious, and they are avoided by application of the bad faith test of the now familiar article 170. Of course, the same bad faith requirement can be abused by unscrupulous purchasers who are aware of the difficulty of proving bad faith in a situation when it cannot be implied from the public register.

The problems with nonpossessory pledges in Poland do not exist under the U.C.C. regime. A nonpossessory security interest in ordinary goods must be perfected by filing a financing statement in the office of the Secretary of State in the state where the goods are located.[142] The financing statement must indicate "the types, or describ[e] the items, of collateral."[143] Thus, the description of the types of collateral (for example, "equipment" or "inventory") is sufficient. There is no need to state the amount of indebtedness or the location of the property. The financing statement must also identify

136. *Id.* art. 527, §§ 1, 2.

137. *Id.* In Roman law, *actio Pauliana* provided for rescission of dispositions of property alienated in fraud of creditors on the assumption that alienation had not taken place. *See* R.W. LEE, ELEMENTS OF ROMAN LAW 433 (4th ed. 1956).

138. For an interesting presentation of six cases of abuse of the current law of secured transactions by unscrupulous borrowers, see MACIEJ H. GRABOWSKI & PRZEMYSŁAW KULAWCZUK, NADUŻYWANIE PRAWA O ZABEZPIECZENIACH PRZEZ FIRMY PRYWATNE [Abuse of Secured Transactions Law by Private Companies] (1992).

139. CIV. CODE art. 308, § 2.

140. *Id.*

141. Szmyt, *supra* note 112, at 6.

142. U.C.C. §§ 9-103(1)(b) and 9-401(1).

143. *Id.* § 9-402(1).

the debtor. It will sufficiently identify the debtor if it includes the debtor's individual, partnership, or corporate name.[144]

In contrast to the Polish Civil Code, the U.C.C. expressly allows granting a security interest in after-acquired property. In order to create a security interest in such property, a security agreement must refer to goods (for example, inventory or consumer goods) now owned or hereafter acquired by the debtor.[145]

In addition to recognizing encumbrances on after-acquired property, the success of nonpossessory financing in the United States is due to the U.C.C.'s adoption of the principle "first in time, first in right" and the efficient functioning of the registration system of security interests. The U.C.C. provides a comprehensive structure for determining priorities between secured parties and other claimants. In general, conflicting security interests rank according to the priority in time of filing or perfection, and the first to file or perfect has priority.[146] As long as the conflicting security interests are unperfected, the first to attach has the priority.[147] Specialized rules applicable to purchase money security interest, proceeds, and future advances may in some situations modify the general rule.[148] Nevertheless, the general thrust of the system is protection of the earliest secured creditor.

As already explained, registration of a security interest requires a filing in the office of the Secretary of State. The secured party must file a simple notice signed by the debtor. The notice may be filed before or after the security interest attaches. The notice gives basic information about the identity of the secured party and the collateral securing its credit. The notice, which the U.C.C. calls a financing statement (UCC-1), is effective for a period of five years from the date of filing.[149] Thus, in financing transactions involving inventory, accounts, or chattel paper, there is no need to refile for each transaction in a continuing arrangement even though the items of collateral alternate daily. Moreover, if the description of the collateral in the financing statement is broad enough, the filing will cover transactions under the security agreement not contemplated when the filing was

144. *Id.* § 9-402(7).

145. *Id.* § 9-204(1).

146. *Id.* § 9-312(5)(a).

147. *Id.* § 9-312(5)(b).

148. A more detailed discussion of exceptions to the general rule is beyond the scope of this Note.

149. U.C.C. § 9-403(2).

made. Also, the filing will apply to after-acquired property and future advances provided for under the security agreement.

Typically, a creditor considering a secured loan will inquire as to the status of proposed collateral by checking whether the collateral is covered by a financing statement. Also, the U.C.C. authorizes the debtor to request that the existing secured party—on behalf of the prospective secured creditor—confirm the debtor's statement regarding the amount of indebtedness and the extent of the collateral covered to a prospective secured creditor.[150] However, the prospective creditor can rely on the statement only to a very limited extent. These statements only speak as of their date and do not impose on the first creditor any limits as to further advances. The first creditor will be fully protected for the advances he makes subsequent to confirming a statement because he was first to file a financing statement. Even knowledge by the first creditor of the second creditor's advances does not prohibit the first creditor from making further advances and is immaterial as to priority between the two creditors.

Thus, once the prospective lender has found a financing statement describing the collateral to be used to protect his anticipated loans, he should request a 9-208 confirmation statement and then do one of the following: pay off the first creditor and terminate the earlier filing;[151] take assignment of the first agreement;[152] convince the first creditor to release part of the collateral so it can be used as security by the second creditor;[153] or enter into an inter-creditor subordination agreement.[154]

As this brief description of the procedures provided in the U.C.C. shows, Polish regulation of nonpossessory pledges is very restrictive. First, only banks can benefit from this type of pledge under the Civil Code. Under the U.C.C., all merchants may take advantage of nonpossessory pledges. Second, Polish law requires a detailed description of the collateral in the pledge contract and does not allow pledges on after-acquired property. The result of the Polish rule is that inventory financing is difficult and cumbersome. On the other hand, a security interest under the U.C.C. does not to have to be very specific and such security interest will cover after-acquired property if the security agreement so provides. The result is a system very conducive to in-

150. *Id.* § 9-208.
151. *Id.* § 9-404.
152. *Id.* § 9-405.
153. *Id.* § 9-406.
154. *Id.* § 9-316.

ventory financing. Additionally, the inventory financier's security under the U.C.C. is protected not only by the borrower's shifting stock, but also by the security interest in the proceeds from the sale of the inventory. Polish law does not provide for the pledge to continue on the proceeds from the sale of the collateral.

Moreover, the Polish rule that gives priority to a pledge created later is faulty. Such a rule is illogical at least in the context of nonpossessory pledges, and it creates an opportunity for abusing the rights of the earlier creditors. Moreover, the provision that causes the pledge to expire when the ownership of the collateral is transferred to a bona fide buyer further weakens the position of a creditor who seeks protection with a nonpossessory pledge. In contrast, the U.C.C. faithfully follows the "first in time, first in right" principle (albeit with important and justifiable exceptions for purchase money security interests and future advances). Short of bankruptcy of the debtor, the secured party has virtually absolute priority over competing interests.

V. CURRENT REGULATION OF SECURITY INTERESTS IN TRANSFERABLE RIGHTS

In addition to pledges on movables, Polish law provides for pledges on transferable rights.[155] As in the case of nonpossessory banking pledges involving tangible personal property, a security agreement creating a pledge on a transferable right must be in writing. For evidentiary reasons, there is an additional requirement of a "date certain" (*data pewna*).[156] It is advisable that the pledge agreement be notarized, although any date affixed by a state institution (*e.g.*, a postmark by a Polish mail service) will satisfy the requirement of the date certain.[157] Unless the establishment of the pledge on a transferable right takes the form of a transfer of a document or its endorsement, written notice to the debtor of a claim by the pledgor is also required.[158] The pledge becomes effective either on the date of a written notice or on the date of transfer or endorsement of a negotiable instrument. In the event that a bank is the pledgee, the pledge is created only on the date on which the entry is recorded on the bank's register.[159]

155. Civ. Code art. 327.
156. *Id.* art. 329, § 1.
157. Herapolitańska & Borowska, *supra* note 60, at 136.
158. Civ. Code art. 329, § 2.
159. *Id.* art. 328.

The Civil Code does not include a definition of transferable rights, nor does it enumerate such rights. There is a widespread consensus, however, that contractual rights, accounts receivable, bank accounts, negotiable instruments, ownership interests in companies, and intellectual property rights all fall under the Code's language.[160]

A. Accounts Financing

The provisions of the Civil Code regulating pledges on movables apply, where appropriate, to pledges on rights.[161] Since article 306, section 2 explicitly authorizes the use of pledges to secure future or conditional obligations, this provision appears to render feasible accounts financing. Applying, by analogy, article 308, section 3 to accounts as collateral, it seems that the banks could take a pledge in a form of a floating charge over existing accounts receivable.[162] The security agreement that pledges accounts receivable should specify in as much detail as possible the accounts pledged. The security interest would attach and perfect at the time of entry in the bank's register. Of course, as with all pledges on transferable rights that do not involve a physical transfer of a document or its endorsement, a written notice to the account debtor would be required.[163]

Nonetheless, banks do not rely upon pledges in the form of floating charges over accounts receivable.[164] The problem of the priority of subsequent pledgees appears to be the major obstacle. Currently, creditors in Poland prefer to secure their loans by an outright assignment of receivables owed to the grantor of the security interest (the account creditor) by his account debtor. The assignment of existing receivables is recognized under Polish law unless the transfer would be contrary to the law, to a contractual stipulation, or to the nature of the obligation.[165] The account creditor may generally transfer the accounts receivable to a third party without the consent of the account debtor. The assignment becomes effective at the time of the agreement between the account creditor and the third party.[166] Technically, a notice to the account debtor is not required. However, since the

160. *See* HERAPOLITAŃSKA & BOROWSKA, *supra* note 60, at 136; Drake, *supra* note 122, at 529; IGNATOWICZ, *supra* note 105, at 265.

161. CIV. CODE art. 328.

162. *See* Drake, *supra* note 122, at 528-29.

163. CIV. CODE art. 329, § 2.

164. *See Full of Western Promise?*, *supra* note 6, at 27.

165. CIV. CODE art. 509, § 1.

166. KODEKS CYWILNY, KOMENTARZ, TOM II [Commentary on the Civil Code, Volume Two] (Jerzy Ignatowicz ed., 1972), at 1220.

account debtor could discharge his debt by a bona fide payment to the account creditor,[167] the assignee should notify the account debtor of the assignment.

The assignment enjoys considerable advantage over the nonpossessory pledge. It results in all claims and rights passing to the assignee, including claims for unpaid interest.[168] In case the borrower defaults, the creditor, as the assignee and the legal owner of the receivable, will make a demand on the account debtor to make payments on the account directly to the creditor.[169] The creditor can thus avoid time consuming and costly court execution proceedings. When the borrower repays the loan, the creditor should return his copy of the assignment agreement to the debtor.[170]

In contrast to the Polish Civil Code, the U.C.C. expressly authorizes the creation of a security interest in accounts receivable.[171] In order to create an enforceable security interest in accounts, the debtor and the secured party must enter into a written security agreement and perfect the security interest by filing a financing statement. A proper place for filing the financing statement is the state where the account debtor has its place of business.[172] Since accounts are a purely intangible property, perfection by possession is not possible.

Priority of security interests under the U.C.C. in accounts follows the general rule that the first to file has priority over conflicting security interests. This general rule will not protect an account creditor who perfected his security interest in accounts of the debtor after the debtor granted a security interest in inventory to the inventory creditor. Such an account creditor will not be protected because a properly filed financing statement covering inventory will cover proceeds from the disposition of inventory.[173] The day of filing or perfection as to collateral such as inventory is also the day of filing or perfection as to proceeds and the first to file rule of 9-312(5) applies.[174] Thus, the inventory creditor will have priority over the account creditor if the inventory creditor filed first as to the inventory and the filing remained proper following the disposition of the inventory.[175]

167. Civ. Code art. 512.
168. *Id.* art. 509, § 2.
169. Herapolitańska & Borowska, *supra* note 60, at 122.
170. *Id.*
171. U.C.C. §§ 9-103(3), 9-102(1)(b).
172. *Id.* § 9-103(3).
173. *Id.* § 9-306(2)(3).
174. *Id.* § 9-312(5), 9-312(6).
175. *Id.* § 9-306(3).

Of course, if the creditor files first as to accounts, it has priority over a competing security interest to inventory. An inventory creditor does not have an automatic claim to the proceeds of the inventory consisting of accounts against someone who has filed earlier as to the accounts.

B. Shares and Ownership Interests in Companies

Shares and ownership interests in Polish companies can also serve as collateral. The Commercial Code explicitly provides for four types of companies,[176] but interests in only two of them, joint stock companies and limited liability companies, are of consequence for secured transactions. A joint stock company issues shares, either bearer or registered, which are evidenced by certificates. A limited liability company has only "ownership interests" which are not represented by certificates of shares of stock.

The Commercial Code authorizes the pledge of an ownership interest in a limited liability company.[177] The pledge must be in writing and must cover the entire ownership interest of the debtor; a borrower cannot successfully pledge just a portion of his interest.[178] Before a bank accepts the ownership interest as security, it is imperative that it carefully review the articles of association of the company. This step is necessary because the articles of association may require prior approval of the company for transfer or pledge of ownership interests.[179] The time the pledge becomes effective varies. As against persons other than the limited liability company, the pledge is effective at the time a written security agreement is reached.[180] As against the limited liability company itself, the pledge of the ownership interest is deemed created at the time the company receives notice either from the participant or the pledgee.[181] Following the notice, the company should record the security interest in the register of the ownership interests maintained by the company.[182]

176. *See* Marek Jakubek & Ryszard Skubisz, *Zagadnienia Wstepne*, *in* ZARYS PRAWA SPÓŁEK [Introduction to the Law of Corporations] 11, 13 (Ryszard Skubisz ed., 1992). For an English language introduction to Polish commercial companies see Jerzy Rajski, *Poland*, *in* LEGAL ASPECTS OF DOING BUSINESS IN EASTERN EUROPE 26-41 (D. Campbell ed., 1992).

177. COM. CODE art. 180.

178. HERAPOLITAŃSKA & BOROWSKA, *supra* note 60, at 138.

179. COM. CODE art. 181; *see also* JANCZEWSKI, *supra* note 40, at 227-30.

180. HERAPOLITAŃSKA & BOROWSKA, *supra* note 60, at 138.

181. *Id.*

182. JANCZEWSKI, *supra* note 40, at 229.

Shares in a joint stock company may also be pledged.[183] There are no restrictions on transferring bearer shares or using them as collateral.[184] However, the articles of association may require a permit from the company before the registered shares can be used as collateral.[185] It is important to note specific restrictions on pledging shares received in return for in-kind contributions to the company. Such equity rights must be in the form of registered shares, and they may not be transferred or pledged until the shareholders' general assembly has approved the financial report for the second financial year of the company's activities following the registration of the company in the commercial register.[186]

Transfer of possession of share certificates is necessary to render the pledge effective.[187] In the case of registered shares there is an additional requirement of a written statement by a pledgor evidencing a creation of a pledge.[188] It is also advisable to record the pledge on the company's share register.[189]

VI. ENFORCEMENT OF SECURITY INTERESTS IN MOVABLES AND TRANSFERABLE RIGHTS

A. *Court Execution Proceedings*

As a general rule, a secured creditor must go through judicial execution proceedings to enforce a pledge.[190] This means that in the case of a nonpossessory pledge, a secured creditor cannot take control of collateral by using peaceful self-help methods. In the case of a possessory pledge, any forfeiture clauses in the pledge contract are not enforceable, so a pledgee does not have an option to retain or sell the collateral in satisfaction of a pledgor's indebtedness.

The practice of foreclosing on a pledge has been rare in communist Poland, and the applicable rules of the Code of Civil Procedure provide for a cumbersome and costly procedure. The special execution officer of the court (*komornik*) is charged with seizing, selling,

183. HERAPOLITAŃSKA & BOROWSKA, *supra* note 60, at 139-40; *see also* COM. CODE art. 348, § 1.

184. Jakubek & Skubisz, *supra* note 176, at 136.

185. COM. CODE art. 348, § 2.

186. *Id.* art. 347, § 1.

187. *See* CIV. CODE art. 329, § 2; *see also* HERAPOLITAŃSKA & BOROWSKA, *supra* note 60, at 136.

188. *See* COM. CODE art. 350.

189. *Id.* art. 351; *see also* JANCZEWSKI, *supra* note 40, at 156.

190. CIV. CODE art. 312.

and turning over the proceeds to the creditor. Obsolete article 865 of the C.C.P. requires the execution officer to first attempt to sell the property to government-run stores at seventy-five percent of market value.[191] If he is unsuccessful, the price can be lowered by another twenty-five percent.[192] Eventually, the movable would be sold at the public auction.[193] In practice, creditors in most cases recover not more than twenty-five percent of the market price.[194] They also must pay a court filing fee which, in some cases, can be as high as twelve percent of the value of the case.[195] In addition, the proceeds from the sale of the collateral go first to pay costs of the execution, alimony payments owed by the debtor, employee wages, funeral expenses of the debtor, and taxes owed by the debtor. Only then are secured creditors' claims satisfied.

It is important to note, however, that, at least for the banks, judicial execution and sale is not necessarily the only method of realizing upon collateral. Clause two of article 312 of the Civil Code provides that credit institutions may provide, in their articles of association, for alternative methods of satisfying repayment of loans secured by a pledge. This has been interpreted as authorizing the banks to provide in their articles of association that upon default, ownership of collateral automatically passes to the bank.[196] Nevertheless, a secured creditor with good ownership title is not authorized to take possession of the collateral against the debtor's will, regardless of whether such repossession can take place without disturbing the public peace.[197] A civil action in the nature of the Roman *rei vindicatio* is required.[198] The secured party will have to prove its ownership and request that the court order the debtor to turn the collateral over to the secured party.

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191. Since virtually all retail stores have been privatized, this provision is a dead letter law.

192. CIV. PROC. CODE art. 866, § 2.

193. *Id.* art. 867, § 1.

194. Ronald A. Dwight, Problems with the Polish Collateral Law System 2 (IRIS-Poland Project release, on file with author).

195. *Id.* 1991 amendments to the Banking Law recognized the excessive nature of the fees and authorized the Minister of Justice to issue an ordinance that would determine special lower fees and fee waivers for execution actions filed by secured creditors. Banking Law, art. 51.

196. HERAPOLITAŃSKA & BOROWSKA, *supra* note 60, at 130. Foreign banks opening subsidiary offices in Poland should keep this possibility in mind and always introduce a forfeiture clause into their articles of association.

197. *Cf.* U.C.C. § 9-503.

198. CIV. CODE art. 222, § 1; *see also supra* text accompanying note 21.

The cumbersome and unsatisfactory regulation of execution on collateral under Polish law becomes clear when compared with the provisions for enforcement of security interest provided by the U.C.C. In contrast to the Polish rules, upon default of the debtor, the U.C.C. secured party has three options: It can enforce its security interest by any judicial procedure; it can use self-help and repossess the collateral; or, it can keep the collateral in satisfaction of the debt.[199]

The single most important difference between U.C.C. regulation of enforcement of the collateral and enforcement under the Polish C.C.P. is the U.C.C.'s recognition of self-help remedies. The U.C.C. permits a secured party to repossess collateral by his own action and without any assistance from the judicial process. It is remarkable that this option is available to a secured creditor even if the security agreement does not specifically provide for it.[200] Repossession takes place without intervention of the legal system, but it is authorized only if it can be completed without a breach of the peace.[201]

Disposition of collateral following repossession may be by private or public sale, but it must be commercially reasonable and it must be preceded by a reasonable notification to the debtor stating when and where the public sale will take place or giving the time after which any private sale may be attempted.[202] The U.C.C. does not explain when a sale is commercially reasonable. One court stated that it had to decide what a reasonable business would have done to maximize the return on the collateral by consulting customs and usages of a particular business or trade.[203] Only if a creditor cannot show commercial reasonableness of its sale need it try to prove the value of the collateral by secondary evidence (*e.g.*, expert witnesses). It is important to note that public sales will not always be commercially reasonable. For example, a public sale may not be deemed to be commercially reasonable when the custom points to other practices.

Finally, following a default, a secured party in possession may propose to the debtor in writing that the secured party retain the collateral in satisfaction of the debt.[204] Notice also should be given to other secured parties from whom the secured party has received a claim to the collateral. If no opposition is voiced within twenty-one

199. U.C.C. §§ 9-501(1), 9-503, 9-505(2).
200. *Id.* § 9-503.
201. *Id.* §§ 9-503, 9-501(1).
202. *Id.* § 9-504(3).
203. In re Excello Press, Inc., 890 F.2d 896, 906 (7th Cir. 1989).
204. U.C.C. § 9-505(2).

days of sending a notice, the secured party may keep the collateral.[205] Thus, silence from the debtor and other secured parties will be treated as acceptance of the retention option. If the collateral is more valuable than the debt, the surplus will have to be returned to the debtor.

B. Conditional Transfer of Ownership as a Means of Avoiding Court Execution

The cumbersome Polish system for enforcement of pledges has encouraged creditors to use other means of securing their loans. One of the most common alternatives is conditional transfer of ownership. Conditional transfer of ownership is a form of real security in which a borrower transfers ownership of the collateral to the creditor with a condition subsequent that when the borrower repays the loan, the ownership reverts to the borrower.[206] The contract should identify the parties to the transaction and the assets whose ownership is being transferred. It should also describe the underlying obligation and regulate the conditions under which the debtor can continue using the collateral.[207]

If the collateral is composed of assets with unique individual characteristics, the borrower is permitted to retain possession of the collateral and use it according to the credit agreement. The use of movables that can be identified only as belonging to a certain class of assets is more problematic, because the ownership of such assets does not transfer without a transfer of possession.[208] However, the required transfer of possession can be effectuated by designating the borrower as a mere bailee of the goods legally owned and possessed by the creditor.[209] Under such arrangement, the debtor can use and dispose of the collateral, providing that he will replace it with items of similar type, quality, and value.

The advantage of the conditional transfer of ownership lies in the mechanism available to the creditor in case the debtor is unable to repay the loan. Upon default, the creditor demands that the borrower turn over actual possession of the property to the creditor. As a legal

205. *Id.*

206. HERAPOLITAŃSKA & BOROWSKA, *supra* note 60, at 143. The Civil Code does not explicitly recognize the conditional transfer of ownership, but the Supreme Court sanctioned its use in 1948. *See Uchwała Izby Cywilnej Sądu Najwyższego z 10 Maja 1948 r.* C. Prez. 18/48, OSN-OP 1948, poz. 58 [Supreme Court Resolution from May 10, 1948].

207. Adam Brzozowski, *Przewłaszczenie na zabezpieczenie* [Transfer of Ownership as a Security], FIRMA, July-Aug. 1992, at 47.

208. CIV. CODE art. 155, § 2.

209. *Id.* art. 349.

owner, the creditor then proceeds with the sale of the property without any need for court execution proceedings. Yet, if the debtor refuses to turn over physical possession, the creditor will have to file a civil action in the nature of Roman *rei vindicatio*.[210]

Conditional transfer of ownership enables creditors other than banks to create a de facto nonpossessory security interest. It also provides such creditors with a somewhat more effective enforcement mechanism in case of the debtor's default. When a bank's articles of association do not explicitly provide for an alternative to court execution proceedings, conditional transfer of ownership may be an advisable option. The most significant advantage of the conditional transfer is that in case of a debtor's bankruptcy the property subject to the transfer is excluded from the bankrupt estate and thus not subject to any competing claims.[211]

VII. PROPOSED CHANGES

Efforts are currently under way to draft legislation that would modernize the law of secured transactions. The Working Group selected by the Civil Law Reform Commission[212] has not yet completed its task of drafting new laws on secured transactions, but an advanced set of drafts already exists.[213] The drafts provide for new forms of nonpossessory pledges, a more reliable system for registering pledges, and simplified execution on collateral.[214]

A. *Proposed New Regulation of Nonpossessory Pledges*

The draft of a new law on nonpossessory pledges is designed to replace current article 308 with a more comprehensive and flexible set of rules.[215] All other Civil Code provisions pertaining to pledges will remain intact and will continue to be applicable to possessory pledges and those aspects of nonpossessory pledges that will not be regulated

210. At least one authority states that the owner may also petition a prosecutor to initiate a criminal action by invoking article 204, § 2 of the Criminal Code, which provides for criminal sanctions for refusing to return the entrusted property. *See* HERAPOLITAŃSKA & BOROWSKA, *supra* note 60, at 146.

211. *See* Bankruptcy Law, art. 28; ZEDLER, *supra* note 93, at 14-16.

212. Interview with Dr. Tomasz Stawecki, *supra* note 8.

213. *Id.*

214. *Id.*

215. Tomasz Dybowski & Sylwester Wójcik, Projekt ustawy o rejestrze zastawów i o zastawie rejstrowym [A Draft of a Law on Registry of Pledges and Nonpossessory Pledges], art. 28 (Dec. 12, 1992) (on file with author).

by the new law.[216] It is anticipated that the new rules replacing current article 308 will be promulgated as a separate statute rather than incorporated into the Civil Code.

1. Creation of Nonpossessory Pledges

The draft responds to the need for a more efficient registration system by giving the responsibility for maintaining the registers to the courts and by restricting the categories of creditors and borrowers who can resort to nonpossessory security. The draft would limit the use of nonpossessory pledges to borrowers who are listed in the court registers of business entities.[217] This restriction effectively limits the pool of possible pledgors to joint stock companies, limited liability companies, limited partnerships, state enterprises, and cooperatives. Banks will be the only lenders authorized to take advantage of this form of secured lending and only loans provided for business purposes will qualify.[218]

The draft provides that a register of pledges will be maintained by the court having personal jurisdiction over a pledgor and not by individual banks as the practice has been under current article 308.[219] Court registration will immensely simplify the verifying process of the status of the collateral. Rather than checking the registers of all the banks for a possible earlier security interest, a creditor will be able to learn about the borrower's status from an appropriate court register.

The registers will be open to the public, and an entry in the register will serve as constructive notice to the rest of the world.[220] This system will most likely stop abuse of the good faith purchaser provision of the Civil Code and provide for stability and predictability in commercial lending transactions. An unscrupulous third party buyer will not be able to take advantage of article 170 of the Civil Code because such third party would probably be acting in bad faith. Bad faith in this case will be defined as actual knowledge of the seller's wrongful title or lack of knowledge regarding the owner's good title due to the buyer's negligence.[221] There is a high probability that the courts will find a buyer who failed to check the appropriate pledge

216. *Id.*
217. *Id.* art. 3, § 1.
218. *Id.*
219. *Id.* art. 2, § 1.
220. *Id.* art. 2, § 2. The proposed second clause of article 2, § 2 states that "[o]ne cannot plead the lack of knowledge of the entries in the pledge register."
221. *See* KODEKS CYWILNY, KOMENTARZ, TOM II, *supra* note 120, at 69.

register to be negligent and thus to have constructive knowledge of the existing charge on the property.

The creation of a nonpossessory pledge will require a written contract and an entry in the court pledge register.[222] The priority of secured creditors will be determined as of the filing date of the petition to enter. An earlier petitioner will be given priority over a subsequent lender. This system will cure the problems created by article 310, which mandates a reverse order of priorities, and will greatly improve the creditor's security.[223]

2. *Recognition of New Types of Collateral to Secure Nonpossessory Pledges*

In addition to eliminating the priority traps of article 310, the new statute would clarify and expand the types of assets that may serve as collateral. Recognizing the primary importance of inventory financing, the draft explicitly provides for floating pledges (*zastaw płynny*) on all categories of movables, including replacement assets and items possessing unique individual characteristics.[224] Furthermore, the draft authorizes the parties to use a borrower's business as collateral.[225] The listing of acceptable collateral also includes accounts receivable, negotiable instruments, securities, bank deposits, and transferable property rights to the pledgor's intangible property.[226] Finally, the draft authorizes the parties to designate as collateral all movables and transferable rights, whether existing at the time of granting a security interest or to be acquired in the future.[227]

The draft also provides that the nonpossessory pledge agreement must contain a description of the collateral.[228] A detailed description setting forth the quantity, quality, and value of the collateral is required. With respect to movables possessing unique individual characteristics, there is an additional requirement of adequately labeling such items at the time the security interest is created.

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222. Dybowski & Wójcik, *supra* note 215, art. 4.

223. Article 310 will continue to be applicable to possessory pledges.

224. Dybowski & Wójcik, *supra* note 215, art. 6, § 1(1).

225. *Id.* art. 6, § 1(2). If real estate is a part of a charged business entity, a secured interest in the real estate would have to be created by a mortgage. *See id.* art. 6, § 3.

226. *Id.* art. 6, § 1(3-6).

227. *Id.* art. 6, § 4.

228. *Id.* art. 7, § 1.

3. *Evaluation of the New Regulations*

Compared to the current regulation of pledges, the draft is a major breakthrough. It significantly expands the types of property that can serve as collateral by authorizing nonpossessory pledges on a business entity and on all debtor's property, whether existing or after-acquired. It specifically provides for floating pledges on replacement assets and accounts receivable. It also solves the problem of priority of secured creditors by implementing the principle of first in time, first in right.

Nevertheless, the draft is not free of defects. The major weakness of the proposed legislation is the exclusion of lenders other than banks from the coverage of the draft. The Polish economy needs credit regardless of its source. Confining the use of nonpossessory pledges to banks will undermine the development of direct credit transactions among manufacturers, merchants, and customers. Manufacturers need credit to acquire raw materials, processing equipment, and tools. Often, rather than applying for a bank loan, a manufacturer may prefer to obtain credit directly from the supplier. Similarly, wholesale and retail merchants may prefer to buy their inventory on credit extended to them by their suppliers. There is no reason why banks should be given preferential enforcement rights over other types of commercial creditors.

It is debatable whether the existing court registers are the optimal place for the registration of pledges. Only limited categories of business entities qualify to have a court register opened in their name. These entities include joint stock companies, limited liability companies, limited partnerships, state enterprises, and cooperatives. Even though sole proprietorships and private farms have played an immensely important role in Poland's transition to a free market economy,[229] they are not subject to registration in the court register. This means that they will be deprived of access to credit secured by a nonpossessory pledge. This is clearly not a desirable outcome, and it can be avoided by instituting a central registry of nonpossessory pledges similar to central registry of secured interests under the U.C.C. Such a central registry should be open to all pledgors and not just a select few. In the free market economy that Poland is striving to build, there should not be special privileges for select players.

229. *See Poland's Economic Reforms: If It Works, You've Fixed It*, *supra* note 3, at 21-22.

Another shortcoming of the proposed law is its failure to extend the nonpossessory pledge to minerals, uncut agricultural crops, and uncut trees. The Roman principle of *superfices solo cedit*, incorporated in Polish law by articles 48 and 191 of the Civil Code, provides that whatever is attached to the land is a part of it and belongs to the owner of the land.[230] The effect of *superfices solo cedit* on secured transactions is that the minerals, uncut agricultural crops, and uncut trees cannot serve as collateral separate from the land they grow on or are located under. Thus, short of mortgaging the entire real property, a real property owner cannot use the minerals, uncut agricultural crops, and uncut trees as collateral. The failure of the drafters to address this issue, if not remedied, may have an adverse effect on the flow of commercial credit to the agriculture, timber and mining industries.

B. Proposed Rules for Execution on Collateral

The proposed changes in the Code of Civil Procedure and the Civil Code would considerably strengthen the position of a secured creditor upon a debtor's default. The new rules would apply only to commercial credits extended by banks.[231] Under the current rules, banks can provide in their articles of association methods of realizing on collateral other than court execution. It is not clear whether this rule will be maintained.[232] However, the draft of a new law on nonpossessory pledges would allow parties to a secured transaction to contractually design the procedure for realizing on collateral upon default.[233] This is a fundamental change from the current law which requires court execution proceedings and does not allow the parties to dispose of this requirement by contract.[234] The draft also provides that before a secured party can take any steps toward enforcing the

230. *See* J. A. C. THOMAS, TEXTBOOK OF ROMAN LAW 210 (1976).

231. There is a debate regarding whether all financial institutions or only selected banks should be granted access to these new procedures. The new rules would not apply to possessory pledges.

232. A draft of a law on nonpossessory pledges indicates that the rule will be preserved. *See* Dybowski & Wójcik, *supra* note 215, art. 13, § 2. Since the draft was prepared, the view of the majority of the Working Group has changed and it is likely that this provision will be eliminated from the final version of the proposed law. Telephone interview with Dr. Tomasz Stawecki, Secretary of the Working Group on Reforming the Rules on Secured Transactions (July 7, 1993).

233. Telephone interview with Dr. Tomasz Stawecki, *supra* note 232.

234. *See* KODEKS CYWILNY, KOMENTARZ, TOM I, *supra* note 120, at 757. The only exception is when a bank's articles of association specifically provide for an alternative form of enforcement.

pledge, it must, in writing, demand a repayment of the loan and inform the debtor of the steps the creditor will take in case the default is not cured.[235] The debtor would have fourteen days to either repay the debt or to file an action for declaratory judgment based on the claim that the debt is nonexistent or not yet due.[236]

1. A Pledgee's Rights After Default Under the New Rules

The detailed rules on the enforcement of a security interest will be included in a new section of the Code of Civil Procedure entitled Execution of Debts Secured by Mortgage or Nonpossessory Pledge.[237] In order to strengthen the position of creditors and simplify execution, the draft envisions that ownership of collateral would transfer to a secured party two weeks after the creditor's final request for payment.[238] In case of nonpossessory pledges on movables, transfer of ownership will be effective upon a notice to the debtor given after the fourteen day final warning period expires.[239] In the case of nonpossessory pledges on transferable rights and real property mortgages, the transfer will be effective upon giving notice to the courts administrating the appropriate land or pledge registers.[240]

In situations when the debtor is cooperating with the secured party, the enforcement of the pledge or mortgage will proceed without any need for judicial process.[241] The secured party, having obtained ownership and possession, will be entitled to keep the collateral as the owner or to dispose of it at will. Of course, the secured party will be required to satisfy all higher priority claims.[242] This will have to be done within a month of transfer of ownership to the secured party.[243] The higher priority claims will have to be satisfied up to the value of the collateral as designated in the security agreement between the party enforcing the pledge or mortgage and the debtor.[244]

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235. Dybowski & Wójcik, *supra* note 215, art. 14.

236. *Id.* When a debtor files a declaratory judgment action, only the court in which the case is pending has the power to determine the rights of the parties and, if finding for a creditor, to issue an enforcement title.

237. Feliks Zedler, Projek zmian Kodeksu postepowania cywilnego [Draft of a Law Amending the Code of Civil Procedure] 3 (Dec. 12, 1992) (on file with author).

238. *Id.* art. 1065(2), § 1.

239. *Id.* art. 1065(2), § 5.

240. *Id.*

241. *See id.* arts. 1065(2), 1065(3).

242. *Id.* art. 1065(5), § 1.

243. *Id.*

244. *Id.* art. 1065(5), § 3.

When a debtor is uncooperative and unwilling to turn over possession of the collateral to the creditor, the latter can ask for the assistance of a court execution officer. The court execution officer will provide help upon the creditor's production of an enforcement title. As already explained,[245] the enforcement title is an executory title signed and sealed by the judge. An agreement in the form of a notarial deed clearly stating the date of repayment of the debt and providing for enforcement by execution from the charged property will qualify as an executory title.[246] Such an agreement serves as a substitute for a civil court judgment against the debtor and is, therefore, highly recommended as a part of any security agreement. Rather than having to litigate a claim, a creditor who produces a notarial deed for the court will have such deed turned into an enforcement title by simply having it sealed and stamped by a judge.

As an alternative to obtaining ownership of the collateral, a secured party can elect to place the collateral under its compulsory administration (*zarząd przymusowy*).[247] Compulsory administration takes effect upon making an appropriate entry in the land or pledge register.[248] Compulsory administration may be an attractive option in cases where a business entity was given as collateral, especially when the entity is expected to produce at least short term operating profits. The court execution officer will extend assistance to a secured party attempting to take collateral under compulsory administration after such party produces an enforcement title.[249]

2. *Evaluation of Proposed Changes*

The proposed changes, if implemented, would significantly improve the position of a secured creditor following a debtor's default. The provision for a transfer of ownership to a secured creditor upon a debtor's default gives the secured party the best title to the property available under Polish law. Moreover, the parties will have full contractual freedom in shaping the enforcement procedures. The parties will also be free to stipulate the value of the collateral. Thus, if a debtor is willing to cooperate with the secured party following the default, there will be no need to invoke the judicial process.

245. *See supra* text accompanying notes 80-81.
246. CIV. PROC. CODE art. 777, § 4.
247. Zedler, *supra* note 237, art. 1065(8), § 1.
248. *Id.* §§ 3, 4.
249. *Id.* § 6.

On the other hand, where a debtor refuses to cooperate, a secured party will be able to avail itself of the court execution procedure. The secured creditor with an enforcement title will receive direct assistance from the court execution officer, who will be charged with taking possession of the property and turning it over to the secured party as its legal owner. This will be done with minimal participation by the court, and in most cases will not go beyond a judge placing a seal and his signature on a valid executory title provided by a secured party. In those rare circumstances when the secured party has failed to obtain the debtor's agreement to the execution on the collateral in the form of a notarial deed, the secured party will have to file *rei vindicatio*.[250]

The weakness of the draft lies in its inadequate attention to the problems caused by the current order of priority of claims to collateral. The draft only proposes to eliminate the most faulty provision, namely the preference given to bank loans, whether secured or not, over secured loans provided by nonbanks.[251] Since the secured creditor's claim will still be preempted by four categories of public claims, this change, although badly needed, does not solve the problem. The drafters should seriously consider giving stronger priority to secured creditors, similar to that available under the U.C.C.

The draft does not envision self-help repossession of movables upon default. Self-repossession is a controversial remedy even in the United States where it is recognized.[252] Nevertheless, it is worth considering allowing a secured creditor to repossess a movable if it can be done without breach of the peace and when the security agreement explicitly provides for repossession.[253] Current Polish law protects possession, including possession in bad faith.[254] A stipulation in the security agreement giving the secured party a right to repossess will not be recognized by Polish courts as valid authority for self-help repossession.[255] The above rules are traditional civil law solutions to prevent abuses of self-help, including harassment by a secured party. Concern about the possibility of such abuses and harassment is under-

250. *See* ZIMMERMANN, *supra* note 20 and accompanying text.

251. *See* Zedler, *supra* note 237, art. 1025, § 1.

252. U.C.C. § 9-503; *see also* McCall, *The Past as Prologue: History of the Right to Repossess*, 47 S. CAL. L. REV. 58 (1973).

253. The U.C.C. gives the secured party a right to repossess even though the security agreement is silent on this issue. *See* U.C.C. §§ 9-501(1), 9-503.

254. CIV. CODE art. 342. Peaceful self-help is authorized, however, when exercised by a possessor during hot pursuit following interference with his property. *Id.* art. 343, § 2.

255. IGNATOWICZ, *supra* note 105, at 286-88.

standable. Still, it appears that in the context of secured transactions, the emphasis should be placed not on the absolute protection of possession but on the efficient means of enforcement of the security interest. There is no reason why the Civil Code should not be amended to grant an affirmative defense to a secured party sued by a possessor without any cognizable title. An affirmative defense should be available to a secured party who repossessed in a *peaceful* manner in accordance with the security agreement, and who can prove her right by submitting a statement from the appropriate register of nonpossessory pledges attesting to her right to property. Current Polish law recognizes a similar exception, which shows that the traditional rule may be superseded when there are strong equitable considerations not to protect wrongful possession.[256]

VIII. CONCLUSION

If Poland wants to compete successfully with other Central and Eastern European countries in attracting foreign capital, it must amend all laws impeding the entry of foreign commercial banks into the Polish market. The laws on secured transactions are a primary candidate for a thorough overhaul. Among limited property rights that have the character of a real security, mortgages and possessory pledges are regulated in a satisfactory manner. Yet, the availability of real property capable of being mortgaged is inherently limited, and possessory pledges are impractical for most business lending except where negotiable instruments, certificated securities, and other similar instruments are used as collateral. Indeed, the pledge as regulated by Polish law can serve a useful function in only two situations: as security in transactions not involving business entities (where collateral used is usually an item of personal property not needed to generate profits), and in those business transactions where collateral is of such a nature that only a possessory security interest is feasible.

Unquestionably, the nonpossessory security interest in personal property has been the lifeblood of any modern commercial system. Yet, the current regulation of nonpossessory pledges in Poland is from another era and is obviously not suited for the operation of market-oriented financial institutions. The lack of a reliable system for regis-

256. The Civil Code gives an affirmative defense to a person who, using self-help, deprived a possessor of his possession but is able to produce during the trial a final decree of the court that the state of possession resulting from self-help is consistent with law. Alternatively, this decree could issue from another state authority entrusted with consideration of similar cases. *See* Civ. Code art. 344.

tering pledges and the reversal of the principle "first in time, first in law" may create unsurmountable difficulties for prospective secured creditors. The ambiguities regarding the creation and enforcement of the floating pledges and the lack of regulations authorizing pledges on business entities and on after-acquired property further limit development of secured credit.

A major revision of the rules regulating procedures for realizing from collateral upon default is necessary. Currently, the secured creditor must go through a judicial process that is complex, expensive, inflexible, and time consuming. The authors of a leading American casebook on Commercial Law, comparing remedies available to a secured creditor under the U.C.C. with those of an unsecured creditor, stressed that "the *unsecured* creditor's legal remedies are restricted to bringing a lawsuit against the debtor, obtaining a judgement, and collecting the judgment by seizing the debtor's property and having it sold—a tedious and expensive process."[257] Ironically, this is exactly the situation of a party *secured* by a non-possessory pledge under current Polish rules.[258] Those inadequate substantive and procedural rules on secured transactions effectively discourage the creditors from relying on traditional forms of securing their credits and force them to use alternative means of protecting their loans, such as conditional transfer of ownership of movables and assignment of accounts.

The proposed changes would fundamentally alter the current inefficient system by addressing virtually all weaknesses in the present regulations of secured transactions. They propose to expand the types of property that may serve as collateral by providing for floating pledges, pledges on business entities, and pledges on after-acquired property. They call for registration of nonpossessory pledges in court registers which are open to the public. They provide that the ownership of the collateral passes to the secured party upon default and give the parties freedom in designing the specific enforcement procedures. Thus, enforcement through the judicial process would be confined to cases where the debtor refuses to cooperate with the secured party.

The fact remains that the proposed changes fail to recognize the advantages of a central registry of liens. They also significantly restrict the use of nonpossessory pledges by retaining banks as exclusive

257. ROBERT L. JORDAN & WILLIAM D. WARREN, COMMERCIAL LAW 1 (3d ed., 1992) (emphasis added).

258. An important exception exists for those banks that provided for an alternative method of execution in their articles of association. *See supra* text accompanying note 196; *supra* text accompanying note 89.

creditors authorized to use them and by limiting the pool of borrowers to entities listed in various business registers kept by the courts. Still, if the proposed changes are implemented, commercial creditors and borrowers would be operating in a transformed environment, one with a much higher degree of predictability and significantly lower transactional costs. This certainty, in turn, should stimulate the much needed commercial lending that is of fundamental importance for Poland in its unprecedented struggle to transform a command economy into a free market system.